



1956

## First National City Bank Monthly Letter Business and Economic Conditions

New York, June, 1956

### General Business Conditions

**T**HE month of May has brought a mixture of good and bad business reports. The strong spots in industry, which in general are the capital goods lines, seem to have become stronger, for new evidence has appeared that business plans for plant and equipment expenditures are still expanding and unfilled orders in these lines have risen further. The soft spots, on the other hand, are softer, with automobile sales disappointing, production cut further, and estimates of the year's output reduced. The leading automobile companies now say that passenger car sales this year will fall below 6,000,000, compared with estimates of 6,500,000 last January, and with 7,400,000 domestic sales in 1955.

In terms of over-all production and trade, it is unlikely that the sideways trend on a high level, which has persisted for a good many months, has been significantly altered. In business comment and sentiment, however, a shift of emphasis is apparent. The buoyant confi-

dence of last winter appears to have given way to a tendency to stress the soft spots. The sharp decline in stock prices both reflects and adds to unsettlement. Money policy has been increasingly criticized. Inventory accumulation and estimates of a reduced level of housing starts have come in for more attention. There are indications that the flow of orders has slackened in some lines, although the evidence is conflicting. During April, the volume of new durable goods orders continued to exceed shipments, and order backlogs rose further.

### *Business Is Spotty*

In a period of mixed reports such as this, there are two ways of looking at almost any item in the news. The cut of over 40 per cent in weekly passenger car production since last December is depressing, but the fact that other activities have absorbed the curtailment with only a minor drop in over-all production and employment should be encouraging. The industrial production index (seasonally adjusted, 1947-49 = 100) edged up slightly from 141 in March to 142 in April as the result of a general advance in durable goods output. Factory employment rose moderately on a seasonally adjusted basis, after declining from November through March. The number of new homes started in April increased somewhat more than seasonally to 106,000 units. To some, these reports are heartening. For others, the reaction is one of disappointment that all three series continue a little lower than they were early last fall, and of belief that they will go lower before they turn up again.

For many months the business trend has been sideways and inconclusive. In some lines the "pause" has been more than a pause; it has cut deep. Yet the country is fortunate in the smoothness with which large-scale adjustments have canceled out, leaving an over-all pattern of stability. The shift from one type of demand to

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another—from an automobile and home building boom to a producers' equipment boom—explains why business is so spotty and why some industries are faced with sales and inventory problems while others experience shortages and delayed deliveries. In some localities and industries, unemployment and business failures have increased; in other areas the pressure on supplies of materials and manpower is great enough to warrant anti-inflationary action.

### The Causes of Concern

In the main, the change in sentiment seems to apply to the short-term outlook. The immediate causes of concern are passenger car inventories, too much steel in the hands of the automobile industry, farm implement curtailment, spotty weakness in some household appliances and textiles, and pessimism about housing. It is plain that many of these weaknesses are real, and that adjustments must occur before the economy is ready to move forward again as a whole. No one can be certain when that will be. But the impression has spread that the third quarter will be leaner than was earlier expected. A longer range concern is whether consumer spending will be affected, or capital goods programs curtailed.

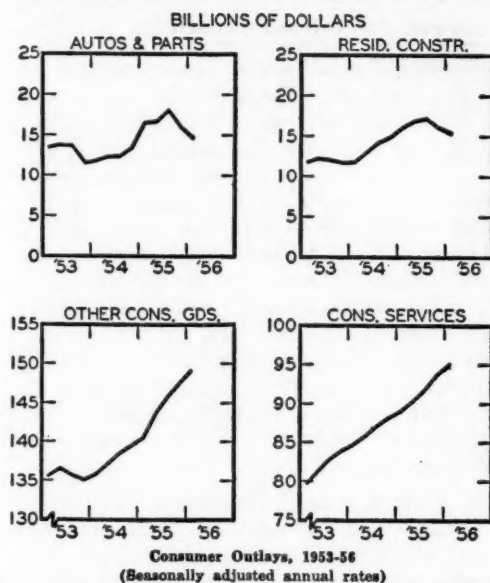
It is hard to feel pessimistic, however, when so much basic strength is visible. An economy straining at the limits of materials, manpower, and financing, as is the case in the capital goods industries today, is not weak, but dynamic. In retrospect it may appear that the moderation of optimism during these recent weeks was timely. The automobile companies are facing up to the problem of high stocks and disappointing sales now, rather than see it get worse during the summer. Further cuts in production must come. But in the fall, introduction of the 1957 models should revive sales. Probably some buyers are holding off for the new cars. Farm implement curtailment is cutting into excess stocks. In business generally it was time for careful examination of inventory policy, after five consecutive quarters of rising stocks.

Judging by available business indicators the economy is neither soaring perilously high nor starting to slide dangerously. Nor is it likely to swing to either extreme in the near future. The best hope for a resumption of long-term growth by the end of this year lies in a speedy completion of the necessary inventory adjustment and a continuation of the strong advance in business spending for plant and equipment. Supports for a high level of activity will come from a gradual increase in government purchases and in the

strength of consumer demand, sustained by record high personal income.

### Consumers Still Buying

Uncertainty about consumers' expenditures is expressed, but consumers have jobs, they have money, and they are buying. Even though they have cut spending for certain products, in the aggregate they are spending more than ever before. The accompanying chart shows how consumer expenditures for goods, services, and new homes has fluctuated over the past three years.



Consumer spending on automobiles and parts (seasonally adjusted annual rate) dropped from \$18 billion in the third quarter of 1955 to \$14.4 billion in the first quarter of 1956. Outlays for new nonfarm residential construction declined nearly \$2 billion in the same period. Yet the steady advance in expenditures for other consumer goods and services has more than offset these declines and carried total consumer outlays to a new peak.

Preliminary indications are that housing expenditures in the second quarter will be no worse than even with the first, on a seasonally adjusted basis. Residential contract awards in the 37 eastern states, according to the F. W. Dodge figures, have set all-time high records, and it is clear that dollar expenditures are running proportionately higher than housing starts. Modernization work is active. Expenditures for automobiles in the second quarter, seasonally adjusted, will prove to be lower, perhaps by 10 per cent, according to one industry estimate.

Gains in expenditures for other consumer goods and services follow a historical growth pattern. Between the third quarter of 1955 and the first quarter of 1956, all major groups in this category advanced at a fairly even pace, averaging about 3 per cent. Many of these items, notably food, rise along with population increases, while others are more responsive to the record levels of personal income and employment. The income freed by lessened spending for cars and new homes apparently has not accelerated the growth of spending for other goods and services. Neither did the abnormally high outlays for new cars in 1955 appear to cut into other types of spending. The answer is found in the sharp increase in extension of new consumer debt during 1955 and the rise in debt repayment this year.

As automobiles and homebuilding complete their adjustments, the consumer sector may once more emerge as an area of strength in the economy. It would not be necessary to have a dramatic recovery in outlays for cars and homes nor a sharp upsurge in purchases of other goods and services. A continuation of the present trend of these other purchases without the offsetting influence of sizable drops in the market for autos and housing would provide steady gains in overall consumer spending.

#### **The Capital Goods Boom**

For the present, however, consumer spending has yielded place to business investment as the dominant force in the economy. Business men, questioned during April and early May by the McGraw-Hill Department of Economics, reported that they were scheduling expenditures on new plant and equipment totaling \$39 billion during 1956. If accomplished, this would represent a spectacular increase of \$9 billion or 30 per cent over the previous record set in 1955. This contrasts with a 22 per cent increase indicated by the Department of Commerce-S.E.C. survey last February. Manufacturers are planning to step up expenditures by 48 per cent this year, and nonmanufacturing industries by 21 per cent. These surveys are not economic forecasts but a compilation of what companies — generally the larger ones — are currently spending and planning to spend. In a great many cases, these anticipations are firmly based on existing orders or construction contracts.

The most encouraging aspect of these investment plans is that they are not a flash in the pan but a part of long-range programs. Fully 88 per cent of the firms surveyed had specific invest-

ment plans through 1959. The degree of uncertainty in these programs increases the farther ahead one looks, but at present business men anticipate spending more on new plant and equipment in each of the next three years than they did in 1955.

These ambitious plans reflect the need which many firms feel for greater and better capacity. They plan to boost manufacturing capacity 8 per cent in 1956. In addition, business men increasingly recognize the greater efficiency and opportunities for cost cutting which can come with newer equipment. One of the greatest forces in industrial expansion is the increasing volume of research and development work. Private expenditures for this purpose — including work on government contracts — have risen from \$3.7 billion in 1953 to an estimated \$5.5 billion in 1956, and are scheduled to increase to \$6.3 billion by 1959. Both through new and improved products and through new machinery and techniques, this research work is hastening the obsolescence of much existing equipment and creating a demand for new investment.

In other words, business investment nowadays is not guided so much by the month-to-month fluctuation of business indicators as it is by the long-run outlook. The capital goods market is not likely to shrink drastically in case of a minor slackening of business activity while long-run prospects remain bright.

Probably materials, skilled manpower, and industrial capacity will not be sufficient to provide all the new plant and equipment that business might want in 1956. Railroads, for instance, expect to increase capital expenditures 62 per cent this year, but the tight supply of steel plates and structural shapes needed for freight cars may restrict outlays. It may be just as well if business does not attempt to crowd all of these outlays into 1956, but carries some of them over to 1957.

#### **Farm Prospects Brighter**

President Eisenhower's signing of the compromise farm bill, following heated Congressional debates, marked the end of the quest for election-year farm legislation. This measure replaces that vetoed by the President on April 16.

The new law provides for a Soil Bank, described by the President as the "heart" of the Act, to pay farmers up to \$1.2 billion annually as an income incentive for taking land out of cultivation. Of this amount, \$750 million will be available to farmers agreeing to withdraw land from production of basic crops (wheat, cotton,

corn, peanuts, rice, and tobacco). The additional \$450 million will be payable for conversion of other cropland to grass, trees, and similar soil-conserving uses on a longer-term basis.

The noncontroversial Soil Bank, designed to reduce current farm surpluses, was included also in the vetoed bill, along with a provision calling for the return to rigid 90 per cent of parity price supports on basic crops. The latter and several other features the President found objectionable on the ground that they would offset the beneficial effects of the Soil Bank with "equal or greater incentive to increase production and accumulate more surplus".

Because the veto came when many 1956 crops were already planted, the President requested the Congress to provide for a Soil Bank to be in operation before fall seeding for next year's crops. In order to boost farm income this year, he also asked the Congress to authorize advance payments of approximately \$500 million upon agreement by farmers to remove acres from surplus crops in 1957. The Congress denied this, but authorized payments for reducing 1956 crops to the extent that the Secretary of Agriculture deems practicable.

The Secretary has promised "generous" payments to farmers who plow under some of this year's crops, as well as to farmers whose crops have not yet been planted. Most Soil Bank participation this year, however, seems likely to come from farmers whose crops have been blighted by drought, disease, or insects.

#### **Compromises in New Act**

The new legislation, in accordance with the President's wishes, abandons the earlier attempt to revive 90 per cent of parity supports — a shift partly compensated for by the President's action under the flexible system in raising 1956 support prices as follows:

(1) On basic crops to levels roughly midway between those previously scheduled under the Agricultural Act of 1954 and those under the vetoed bill, and (2) on dairy products to the levels called for in the vetoed bill.

The President was forced to accept an increase in 1956 supports on feed grains (other than corn) from 70 to 76 per cent of parity with no restrictions on plantings. This measure, while not pleasing to the Administration, was preferred to the 85 per cent of parity supports for these feed grains called for in the vetoed legislation.

As a further concession, the Administration agreed to the freezing for another year of the present "transitional" parity prices for wheat,

corn, and peanuts — this in place of a 5 per cent reduction previously provided.

Sharpest setback for the Administration was in the provision of the new law calling for mandatory disposal of surplus cotton stocks in world markets at competitive prices. The Administration had opposed forcing such sales on the ground that they would be regarded as "dumping" by rival exporting countries and garner a harvest of ill will among many friendly peoples. No sooner had the bill been passed than the Uruguayan Minister to the United States, Washington P. Bermudez, warned that its approval would start a "price war in the cotton markets of the world." Characterizing the cotton provision as a "large scale dumping scheme" he asserted that it would harm South American countries particularly because CCC stocks are largely short-staple cotton of the type grown there.

Other features of the new law to which the President objected were freezing of cotton and rice acreage allotments for two years, and a discretionary two-price plan for rice.

The new law also increases 1956 corn allotments to 51 million acres from the 43 million acres previously established, boosts funds for purchases of pork and other perishables in temporary abundance, and authorizes payments to cover ocean freight on surpluses disposed of through welfare organizations.

#### **Farm Prices Improved**

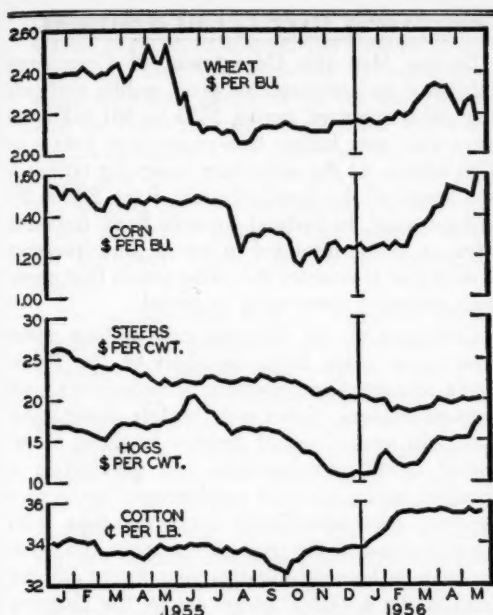
Meanwhile, farmers, while not oblivious to Washington, have been more immediately concerned with prices, costs, and weather conditions.

As regards prices, recent developments have been more cheering to producers. Values have been moving upward and by mid-May the index of prices received by farmers was 242 (1910-14=100), up 9 per cent since December when farm prices were nearly 30 per cent below their all-time high in February 1951.

Since costs of goods and services used in production have risen more slowly, the index of farm prices received to farm prices paid (the so-called parity ratio based on the 1910-14 average as 100) has advanced to 85 from December's 80.

The following chart showing central market prices of major income-producing farm products reflects this improvement. Hogs, all-important in the Corn Belt economy, are up from around \$10 to a top over \$18 per hundredweight in Chicago.

The improvement in farm prices has been in part seasonal, accompanying the customary



Central Market Spot Prices of Five Major Farm Commodities

spring dip in hog marketings and tightening of free supplies of wheat, corn, cotton, and other crops due to heavy entries under price support. But factors other than seasonal have also been influential. Confidence generated by the increase in price supports on 1956 crops and dairy products by the Administration has played a part. Reports of poor wheat prospects in several European countries have contributed to firmer wheat prices, while reduced olive oil production in Mediterranean area countries has buoyed prices for soybeans and related products.

With prices of farm products undergoing some betterment, the chief discouraging element in the farm picture has been the adverse weather conditions this spring which have plagued farmers as well as business generally.

While contributing to the improvement in farm prices, the adverse weather conditions have at the same time tended to water down gains in farm purchasing power accruing from higher prices, and to act as a psychological depressant where farmers face severe actual or threatened crop losses.

Given a more favorable turn in the weather it is still possible, with modern methods of farming, that some of the ground lost may be regained. Late May rains have already brought some improvement to pasture and hay crops. Finally, some farmers may be able to recoup financially by recourse to the Soil Bank.

### Farm Price and Income Prospects

Looking ahead, prices of wheat and other small grains are expected to be under seasonal pressure (already in evidence in the case of wheat) during harvesting. Later in the year, wheat prices may stiffen under the influence of price support entries, particularly if the crop is no larger than now estimated. Crop prospects and the extent of the apparent cut in spring pig production will largely determine corn prices which normally reach their lows in late fall. But with free supplies of 1955 corn limited, spot prices are likely to remain firm until new crop supplies are available.

As regards both wheat and corn, support prices fixed by the President for the '56 crops, while lower than those for the '55 crops, are above the levels originally looked for this year under the flexible program. Establishment of a support price for commercial corn growers not complying with acreage restrictions is an additional income-boosting factor.

In the case of hogs, the Department of Agriculture foresees during the heavy marketing period a firmer price level this fall than last. Certainly, a repetition is unlikely of last fall's panicky selling when packers, swamped with more hogs than they could handle at corn belt concentration yards, often requested farmers to delay marketings until a later date.

Cattle prices have been relatively weak, but prospective lower market supplies, due to fewer numbers on grain feed, suggest a good rise in top grades of slaughter steers and heifers this summer or fall. Lower grades, in view of the record numbers of cattle and calves, may display continued weakness unless pasture and range conditions undergo improvement.

Milk prices paid to farmers have averaged slightly above a year ago. Cancellation of scheduled seasonal cuts in prices paid for fluid milk sold under federal marketing orders, along with the increase in supports on butterfat and manufacturing milk, indicate continued strength in prices of these products. With milk output at a record, purchases of dairy products under the price support program are running above a year ago. Everything considered, larger supplies and higher prices indicate that 1956 dairy income will exceed 1955.

Based on higher-than-a-year-ago hatchings of chicks, larger supplies of eggs and poultry meat are expected after mid-summer. Low storage stocks of eggs and continued culling of old hens from laying flocks, however, may keep egg prices relatively strong.

Cold weather in the South, delaying early vegetable crops, together with government diversion of 1955 potato supplies to manufacture of starch and livestock feed, has pushed potato prices up very sharply. Damage from unseasonable weather has also resulted in higher prices of fruits and vegetables generally.

Probably few people realize that dairy products, poultry and eggs, vegetables, and fruits account for more than one-third of total farm cash receipts.

For cotton farmers, slightly lower acreage allotments and a drop of nearly 3 cents per pound in price supports below those for the 1955 crop presage a decline in income, even if last year's record yield per acre is repeated. Nevertheless, the cotton support rate ordered by the President is higher than current surpluses would have required the Secretary of Agriculture to set under the price support formula and, as in the case of wheat and corn, higher than that anticipated earlier in the season.

The foregoing factors in farm price and income prospects are apart from any 1956 payments that may be made under the Soil Bank; also from funds available to the Department of Agriculture to boost prices of perishable products. Materialization of the expected increase in funds under the "Agricultural Trade Development and Assistance Act of 1954", which provides among other things for sale of farm surpluses for foreign currencies, would also be a source of price strength.

#### **A Significant Change**

Although these programs may not prevent the full year 1956 farm prices and incomes from averaging below 1955, the point is that their decline is probably behind us. As stated above, farm prices and income prospects have been on the mend, and while not all of recent gains may be held, a return to last year's lows seems, all things considered, unlikely. Moreover, with the Soil Bank coming into full operation next year, this improvement should carry over into 1957.

This is a significant change in the situation, not only for agriculture but for business generally. While the long-range effectiveness of the Soil Bank plan must be considered still an open question, particularly in view of the compromises forced on the President in the form of higher price supports with their incentive to expand production, it looks as though, temporarily at least, the fortunes of the farmer may have turned the corner. One of the major so-called "soft spots" in the national economy seems to be getting a little harder.

## **Controversy Over Credit Restraint**

During May the Department of Commerce published an estimate that gross public and private debt increased during 1955 by \$61 billion — more than ever before in a peace-time year — to \$768 billion. At the same time widening criticism was heard of the April advance, from 2½ to 2% or 3 per cent, in Federal Reserve Bank discount rates, an action intended to retard the expansion of debt and to counter the rising prices that come from excessive borrowing to spend.

Criticisms of the discount rate actions came from many sides, from members of the President's cabinet, Congressmen, homebuilders, and business leaders. Fears were widely entertained that tight money would deprive business of essential credit requirements and precipitate a slump in production and employment. Some people were more specifically concerned that, with the tightening of the mortgage market, the number of new homes built this year might fall far short of the 1,300,000 target set by the Housing and Home Finance Administrator. Others held that a less easy availability of instalment credit was a responsible factor in the decline of automobile sales. Still others expressed apprehensions that small and marginal businesses would be deprived of credit and go under, or that municipalities could not sell bonds to pay for essential schools, roads, and sewage systems.

Secretary of the Treasury George M. Humphrey publicly disclosed his reservations about the April discount rate decision when he told the Senate Finance Committee on May 17: "If it were my responsibility, I would not have made the last move. I would have let natural conditions take their course. I agreed with all the other moves but the last one." Secretary of Commerce Weeks, Secretary of Labor Mitchell, and Chairman Burns of the President's Council of Economic Advisers had indicated similar doubts, though, as in the case of Secretary Humphrey, they did not question the Federal Reserve's final authority in the matter.

Most striking were the criticisms emanating from among business leaders, which illustrated that the action had taken effect in tempering the optimism of the business community. A purpose of the rate advance was to lead borrowers to space out their projects and not imperil price stability by trying to do too much at once.

#### **Excessive Credit Demands**

Unfortunately, we will never know what would have happened if the action had not been taken. The results of the new McGraw-Hill survey of

business plans for capital spending in 1956, released May 18, confirmed the Federal Reserve's appraisal that the economy is continuing to make excessive demands on the savings stream and on available supplies of labor and material for construction. The same conclusion emerges when one observes the trends of credit volume. If money is tight it is not because lenders are not doing an active business but because demands for borrowed money are in the aggregate so heavy.

To be sure the cost of borrowed money is higher. Interest-bearing securities and savings accounts are paying higher rates. Lenders have been turning away many applicants for credit, particularly where the purpose of the loan is to finance a transaction of dubious merit or where the would-be borrower is trying to do too much of the job with other people's money and too little with his own. There is no occasion for any special squeeze against small business though naturally the weakly capitalized and financed enterprise—big or small—has the most trouble raising borrowed money.

#### Another 1953?

On the other hand, it is far from the truth to suggest that credit stringency is choking the normal growth of the economy. The seeming parallel of the April-May 1953 credit squeeze, which was followed by the 1954 business recession, is in everybody's mind. The same words are used to describe the present state of the money market, though the psychology is radically different. In April-May of 1953 active concern developed that credit might not be provided for autumn requirements and there were no official reassurances that this view was mistaken. Banks now are borrowing just as heavily as then and the discount rate is higher. But there is no justification for a view that the authorities are unmindful of the needs of a prosperous economy for credit. Experience has taught that they are willing to make reasonable provisions.

In the summer of 1953, and again in 1954, the Federal Reserve Board eased the cash reserve requirements of the banks to provide for autumn credit needs. If it seems desirable, the Board can repeat this action. Moreover, unlike 1953, few responsible persons now believe that the Federal Reserve banks will attempt to shut off banks' use of the discount facility. The contribution of the Federal Reserve Act to the American credit structure was the provision of elasticity in the supply of credit through bank borrowings from

the Federal Reserve. The availability of the discount facility provides assurance against absolute unavailability of credit at any price for legitimate purposes.

Finally, Federal Reserve purchases and sales of government securities in the open market, judiciously timed, can take the edge off periods of peak pressure on the banks, as well as absorb slack that occasionally appears. As in the early months of other years, the Federal Reserve authorities so far in 1956 have been sellers on balance of government securities, though not in amounts much greater than usual, and bankers can confidently expect that they will become buyers in the second half year. The rising pressure in the market, apparent in open market rates and recognized in the discount rate advances, has originated out of the abnormal strength of loan demands, not out of Federal Reserve actions arbitrarily to place the credit structure under strain.

#### A Record Loan Expansion

While recognizing that loans are getting turned down or reduced in size, it is necessary also to consider the scale on which loans are being granted. Partly by selling investments, partly by working harder to get deposits, and partly by borrowing from the Federal Reserve Banks, banks have put on more loans so far this year than ever before in a January-May period. For the weekly reporting member banks of the Federal Reserve System, over the six weeks following the mid-April discount rate advance, business loans increased \$410 million compared to a rise of \$98 million in the corresponding period of 1955. In evaluating this comparison it should be borne in mind that April and May are normally months of seasonal contraction in loans and that 1955 went on to develop a record increase for the whole year.

Loan Changes, Weekly Reporting Member Banks

(In billions of dollars)

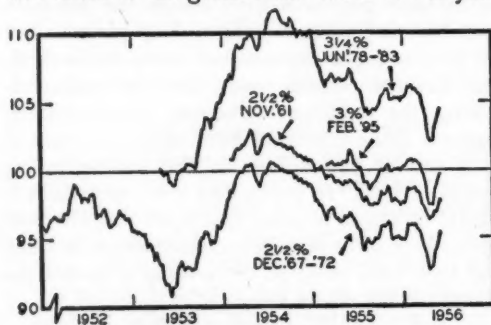
	Six Weeks Ended May 23, 1956	May 25, 1955	Year to Date 1956	Year to Date 1955	Full Year 1955
Business loans	+0.4	+0.1	+1.4	+0.2	+4.3
Security loans	0.0	0.0	-0.4	0.0	+0.3
Real estate loans	+0.1	+0.2	+0.3	+0.5	+1.0
Other loans	+0.3	+0.3	+0.6	+0.6	+1.9
Total loans	+0.8	+0.6	+1.9	+1.3	+7.5

In other credit categories, despite the discussion of stringency and the fact of higher rates, lending has gone forward at a brisk rate. Consumer credit—which some had suggested might have to be restrained by special federal regulations—has continued to increase though at a slower and less unsustainable pace than in 1955. The complaints of shortage of mortgage credit

must be considered against the indications that life insurance companies, savings and loan associations, and savings banks, taken collectively, are supplying to this market practically as much money as last year. If, as seems likely, many fewer homes are built than last year the responsibility will rest on the increase in nonresidential building, the higher construction costs and the tendency to build better and more expensive homes requiring bigger mortgages.

The capital market in May was functioning at an active pace rarely equalled in the past. Bonds, which had suffered a major decline between mid-February and mid-April, developed a strong tone. Heavy volumes of new issues were absorbed at rates running as low as  $3\frac{1}{2}$  per cent for highest grade corporate issues and as low as 2% per cent (exempt from federal income taxes) for issues of States and municipalities with the highest credit ratings.

The Treasury bond market rebounded sharply during May, influenced by anticipations that the restrictive credit policy might be moderated, as well as, during the latter part of the month, by indications that the Federal Reserve was entering the open market to relieve apprehensions of undue tightness over the June tax period. As the chart suggests, many issues recovered about two-thirds of the ground lost earlier in the year.



Friday Closing Bid Prices, Selected U.S. Government Bonds  
(Last plotting for Thursday, May 31)

### The Critics' Case

Critics of the discount rate advance do not necessarily accept the facts cited earlier as convincing. They interpret the further business loan increase as evidence of inventory accumulation. They point out that, apart from normal seasonal influences, industrial production and retail trade since last fall have been running no better than even and would be lower except for a temporary influence of inventory accumulation. Liquidation of inventories, it is felt, will cut production schedules for automobiles and steel during the third quarter, with depressing influences on pay-

rolls that might bring, in the fourth quarter, reductions in trade, further inventory curtailment, and a scaling down of capital spending programs. The Federal Reserve, some felt, should have waited a month or two at least before acting on the evidences of excessive borrowing and current price trends. A tightening of credit supply ran the risk that it would simply precipitate or insure a downturn already in the making.

In a speech May 24 Allan Sproul, retiring president of the Federal Reserve Bank of New York, commented on the criticisms of the continued policy of credit restraint. Noting that "criticism is the normal lot" of a central banking system, he stated in part:

It is always possible, as in this case, for reasonable men working with the same set of facts to come to different conclusions in the still imprecise field of economic analysis. This is particularly so when the economy is moving along a high plateau, and when there is no clearly apparent and dominating force which is likely to cause it to resume its upward journey or to send it down into one of the valleys of recession that lie along the way . . .

For my own part, in trying to assess the existing situation and to pierce the haze which conceals the exact course of the road ahead, I would say we had to look closely at the behavior of prices, of the capital markets, and of bank credit, recognizing that in the whole range of economic forces which determine the level and trend of employment and production, these are but three factors, albeit important ones. Certainly they are factors which are close to the responsibilities of the Federal Reserve System.

It must always be repeated and remembered that the monetary authorities are not economic dictators, for which we can all be thankful. If they do their job well, and if the fiscal authorities and other branches of Government do their jobs well, and if management and labor conduct themselves with some degree of economic intelligence or enlightened self interest, and if the consumer exercises his sovereign rights with some degree of steadiness, we can hope to achieve sustainable economic growth. But the Federal Reserve System can only contribute to or subtract from the overall result.

After noting the rising trend of prices, and strains on productive capacity in some industries, Mr. Sproul went on to say:

In the capital markets there has been recurring evidence of a tendency for capital demands to outrun the currently available supply of savings, with consequent temporary congestion and some seepage of bank credit into capital uses. We have been in transition from a period in which consumer investment in houses and durable consumer goods was the dominant expansive force in the economy to a period in which business investment in plant and equipment is the dominant force. Such periods of transition, which are natural in a dynamic economy free of most central planning, are likely to be periods of delicate balance.

Observing the responsibility to meet necessary demands for bank credit, he questioned whether too great restraint had been imposed:

When it comes to bank credit, it is hard to find evidence of too great restraint on business borrowing. The use of bank credit by business has been larger during the present year than can easily be explained by a business situation which, in the aggregate, has been moving sidewise except possibly in terms of inventory accumulation and reduced business liquidity. After a less than seasonal decline in business loans during the first two months of the year, there was a sharp upward thrust in March, which has since been confirmed, and the prospective demands of coming weeks, which include the June 15th tax payment date, are heavy.

There has been no shying away by the Federal Reserve System from its responsibility to supply the reserve funds needed to meet necessary demands for bank credit, whether temporary or continuing. And I would expect that there would be no shying away from that responsibility in the future, whether over the next month or later when seasonal needs for credit are supposed to make their appearance.

But with this responsibility goes the equal responsibility of trying to see to it that bank reserves are not so readily and cheaply available as to foster and promote expansive efforts which are temporarily beyond our physical capacity for balanced growth. It seemed to me at least that, rather than run this risk, it would be better to give public notice, by way of an increase in the discount rate, of the pressure being exerted on the commercial banking system by business demands for credit. In this way the banks would be further encouraged to make adjustments within their own loan and investment portfolios to meet these credit needs, and to screen more carefully the necessary demands for credit from the speculative or fringe demands.

### **Effects On the Outlook**

There can be no question but that the discount rate action, giving public notice as Mr. Sproul put it, of the pressure on the credit structure, and stirring widening discussion of "soft spots", led business men and investors quite generally to recheck the outlook. The seeming parallel with the situation in 1953 gave credence to the thought that business was due to turn down.

We have here an illustration of the "psychological" effect of discount rate action, altering the atmosphere in which business decisions are made. The plausibility of a recession sequel may well explain the lightened inflow of new orders some manufacturers experienced during May, as well as the setback of common stock prices. It would be surprising if the caution in the air does not affect the deliberations of the steel-wage negotiators who this month are gathering around a table to decide how much increase in labor cost they can properly call upon the economy to absorb. If they do not give heed, they will be asking the Federal Reserve to give the American people another dose of inflation so that they may enjoy the illusion that rising prices and wages represent a sound formula for prosperity.

The benefit of the discount rate action can be enlarged if, by checking the tendency of people to buy ahead with borrowed money in expectation of price advances, the tempo of the economy is moderated. Really serious collapse comes out of indulgence of booms founded on swollen borrowings and forward commitments. This is the general experience in our own history as well as in that of nations abroad. If the discount rate action effectively pricked a dangerous bubble, it is well that the action was taken before the bubble grew any larger. Inaction would simply have let the hazard grow, inviting people to plunge ahead on the assumption that no one dared stop the spiral.

### **The Budget**

The discussion of needs for restraint on private credit has tended to draw attention away from federal budget policy, which is at least equal in significance to credit policy in terms of economic stability and of even greater significance in terms of economic progress. In a speech at Boston on May 21, Arthur F. Burns, Chairman of the President's Council of Economic Advisers, noted how great numbers of ordinary citizens had learned, out of experience, that "inflation is not an act of God" and that "a mature people should be able to conduct their private and public affairs so as to avoid both deflation and inflation".

Dr. Burns noted the practically universal recognition, at home and abroad, of "the need for monetary discipline" as a major force to promote price stability. He went on to point out:

Experience is also teaching the nations of the world that the effectiveness of traditional monetary restraints has been reduced as a result of growth in the economic scope of the public sector. Under modern conditions an exacting fiscal discipline and some funding of the public debt may well have to accompany monetary restraints when inflationary pressures mount.

Prospering business has been good for U.S. tax revenues. The estimate of federal receipts for the current '56 fiscal year ending June 30, put at \$60 billion when the year's budget was initially prepared back in January, 1955, has been progressively raised to a point where, on May 17, the Administration announced a prospect of \$67.7 billion, more money than the Federal Government has ever before collected in a year's time. Despite this favoring swing, as the following table shows, the prospective surplus amounts to no more than \$1.8 billion, permitting a modest retirement of federal debt but discouraging the idea of a 1956 tax cut so much counted on a year ago as a support to business this year. Leaders

of the Administration and of both Houses of Congress agree that this is no time to reduce taxes further.

#### Federal Budget Receipts and Expenditures

(In billions of dollars)

Fiscal Year	Expenditures	Receipts	Surplus (+) or Deficit (-)
1951	44.1	47.6	+3.5
1952	65.4	61.4	-4.0
1953	74.3	64.8	-9.5
1954	67.8	64.7	-3.1
1955	64.6	60.4	-4.2

#### Estimates for Fiscal 1956

Jan. '55	62.4	60.0	-2.4
Aug. '55	63.8	62.1	-1.7
Jan. '56	64.3	64.5	+0.2
May '56	66.9	67.7	+1.8

The balanced budget—the fourth in twenty-four years—fulfills a prime objective President Eisenhower set for his Administration when he took office. A surplus is particularly welcome to the Treasury at this point since federal debt retirement can chisel down the \$60-odd billion floating debt and release funds which can help provide markets for obligations of State and local governments, corporation bonds, and mortgages.

#### Bigger Surplus Needs

Nevertheless, it would be better if the surplus were larger, not only to speed debt retirement under prospering conditions, but also to create a position where a weakening of business can be countered by tax reductions within a prospectively balanced budget. There are limits to a country's endurance of taxation. Under our present progressive income tax structure, prosperity automatically raises effective tax rates to an ultimate point of stifling opportunities for private spending and saving. Thus renewed and sustained prosperity within a stable peace-time economy needs renewed and sustained attention to the revenue laws. The 1954 tax revisions provided an example of what constructive and imaginative revenue legislation can do to stimulate enterprise. But the pressing problem of income tax rate reform was left for later action. Preparations should be made to move ahead on this front. The way to start is to build surplus.

The trouble is with the curve of expenditures. As the table brings out, spending estimates have been raised every time the fiscal '56 budget outlook has been recalculated. While part of this represents a cost of inflation, and additions to the defense budget, the record also reflects the natural human tendency of Congressmen to be generous in disbursing public funds when the revenues are flush. To get restraint on federal spending we need more than public support for a balanced

budget. We need also public demands for easing of federal taxes.

Assuredly, we would be in a stronger position with a larger surplus and the opportunity to proceed with tax reduction. As it is, any slackening in business invites recourse to the artificial stimulant of easy money so that people can compensate the excessive tax load by building up their debts. It would be better to let people keep more of their earnings to spend for themselves. If the economy bogs down it will be the tax load, not unavailability of cheap money, that will be fundamentally responsible.

#### Government in Business

Government competition with private business is an old problem, even in this country with its tradition of private enterprise. Some of this competition dates back a great many years. Most of it stems from World War I, the great depression of the 1930's, and World War II. Not until recently, however, has information been available to enable the people to see how big government-in-business really has become.

In what was described as the first complete inventory ever made of federal commercial-industrial activities, Percival F. Brundage, Director of the Bureau of the Budget, last month revealed that such enterprises total 19,771, employ 258,425 civilians, and have capital assets amounting to nearly \$11.9 billion.

Mr. Brundage characterized the inventory as "another step in the Administration's long-term program to eliminate unnecessary government competition with our free enterprise system." It is in line with the philosophy expressed by President Eisenhower of keeping the Government out of business, stated in forthright language in a speech in St. Louis on September 20, 1952:

To bring government closer to the people we will set up these principles and adhere to them: That no federal project, large or small, will be undertaken which the people can effectively do or be helped to do for themselves; that no federal project will be undertaken which private enterprise can effectively undertake; that no project and no program will be started on the federal level which can be undertaken and effectively carried through on the State or local level.

#### Getting Government Out of Business

That the Administration has been making headway in trimming down governmental commercial activities was brought out in the Brundage report. The Department of Defense, it was stated, has terminated some 32 types of commercial-industrial activities. These have been ended at 246 installations, and at 58 more they are in process of termination.

The General Services Administration, the Government's "housekeeper", has turned to private concerns for some 60 categories of services. The Reconstruction Finance Corporation has ceased making advances and is in process of liquidation. All 27 synthetic rubber plants built during World War II have been sold to private industry on terms substantially in excess of cost. The Inland Waterways Corporation has likewise been sold to private enterprise. The Atomic Energy Commission is getting out of the business of owning and operating the homes, stores and other community facilities at Oak Ridge, Tennessee, and Richland, Washington. Farm credit institutions are gradually being converted from government-owned to farmer-owned enterprises, the Budget Director stated.

This is an impressive list of accomplishments. But much remains to be done. The Commission on Organization of the Executive Branch of the Government (Hoover Commission) reported to the Congress a year ago that the total number of government commercial-and-industrial type facilities in the Defense Department alone "probably exceeds 2,500". Among the 47 categories of such activities were such items as coffee roasting plants, tree and garden nurseries, false teeth factories, ice cream manufacturing plants, laundries, and scrap processing plants. Of the 2,500 total, the Commission said probably 1,000 individual facilities could be eliminated "without injury to our national defense or any essential governmental function."

#### **Obstacles to Doing the Job**

The record shows, as noted above, that business-type enterprises of government are generally the outgrowth of periods of economic or war emergency. The trouble is that these enterprises, once embarked upon, continue to operate long after the emergency has passed. In the main, the reasons for this are two-fold:

The first is just plain inertia. Some business activities carry on over the years simply because no one has bothered to reassess their need. Mr. Brundage cited an example in testimony before a Senate Small Business Subcommittee last year when asked how the Government ever got engaged in coffee roasting: "I believe that dates back almost 100 years . . . There was a complaint about the coffee and so the military serv-

ices started to buy the beans and roast them and grind the coffee. It has been done down to this date. That is an example of how some of these things started and have been carried on without current reappraisal."

The second obstacle is likewise an old story, but offers tougher resistance — the opposition of those who are the current beneficiaries of these activities. As the Hoover Commission stated in its May 1955 report to the Congress:

One reason that these agencies tend to perpetuate themselves is that by the time their tasks have been completed their personnel and the citizens in the communities where they operate resist termination. Because of vested interests, misleading or incomplete accounts, or other reasons, some of these enterprises have established an astonishing longevity. A classical case of this phenomenon dating from World War I was the Inland Waterways Corporation which survived for 33 years — and lost money practically every year. It was typical of the vested interests created within and around it.

Many other cases could be cited, including local resistance to abandonment or removal of unneeded military posts and naval facilities, veterans' establishments, and the like. Unfortunately, such resistance too often emanates from business interests and others who on other occasions are quite ready to pass resolutions denouncing government waste and extravagance, and calling for stern economies and reduction of taxes.

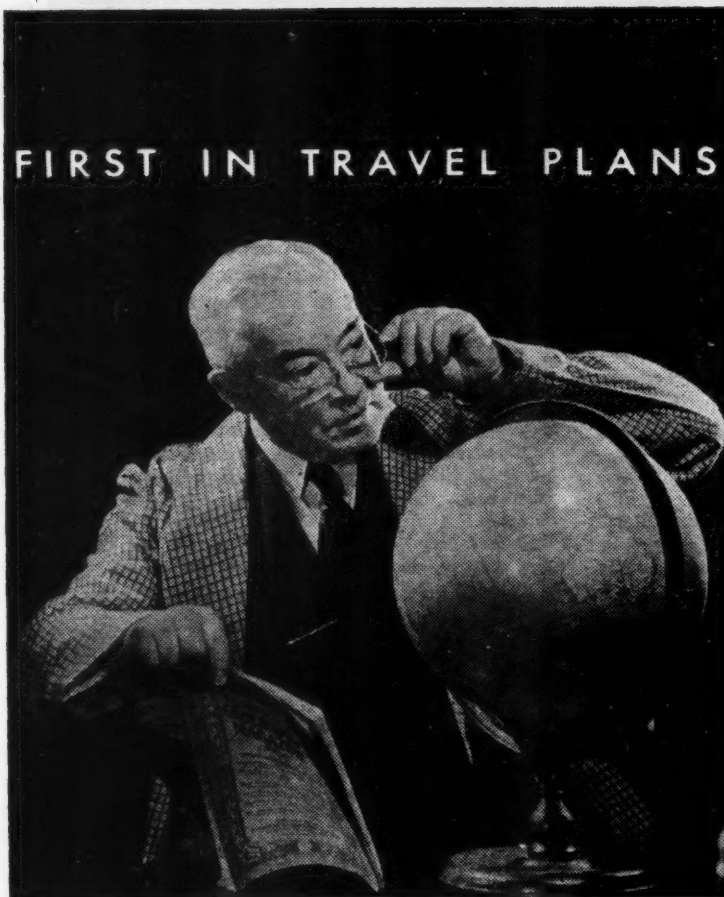
#### **Public Support Essential**

Government-run businesses, generally speaking, pay no taxes and no interest on the capital invested. Thus they deprive the Government of taxes that otherwise would be paid were private businesses conducting these operations. Still more important, with the advantage they receive from government, they are unfair competition with private industry upon which this country traditionally depends.

The inventory just completed by the Budget Bureau is evidence both of the widespread proliferation of these government-in-business activities and of the determination of this Administration to press forward in cutting them down to size. To really succeed, however, these efforts must have the support of businessmen and the public at large, not just when they affect the "other fellow" but when their own industries and localities are involved.

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